

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re:

CHRISTOPHER PHILLIPS,
Debtor.

C09-1399Z
ORDER

STANDARD INSURANCE COMPANY,
Plaintiff/Appellee,

v.

CHRISTOPHER B. PHILLIPS, Debtor,
Defendant/Appellant,
and NANCY L. JAMES, solely in her
capacity as chapter 7 Trustee for Christopher
Phillips,
Defendant/Appellee.

THIS MATTER comes before the Court on appeal from two separate orders issued by the United States Bankruptcy Court for the Western District of Washington (the “Bankruptcy Court”). The appeals were initially assigned different cause numbers, but they were subsequently consolidated, by stipulation of the parties, into this action. See Minute Order at ¶ 1 (docket no. 10) (consolidating Case No. C09-1422Z into Case No. C09-1399Z). Having

1 reviewed the opening, response, and reply briefs, as well as all other materials submitted by
2 the parties, the Court now enters the following Order.

3 **Background**

4 In December 2002, Standard Insurance Company (“Standard”) issued a disability
5 income insurance policy to debtor Christopher Phillips. Letter Ruling at 2 (Bankr. W.D.
6 Wash. Adv. No. 08-1338 at docket no. 15), Exh. A to Livesey Decl. (W.D. Wash. Adv.
7 No. 08-1232 at docket no. 18), Appellee’s Appendix of Record (docket no. 23 at 169)
8 [hereinafter “Letter Ruling”]. In March 2008, debtor submitted a claim for benefits under the
9 disability income insurance policy. *Id.* In July 2008, debtor filed a Voluntary Petition under
10 Chapter 7 of the Bankruptcy Code. *See* Voluntary Petition (Bankr. W.D. Wash. Case
11 No. 08-14147 at docket no. 1), Appellee’s Appendix of Record (docket no. 23 at 5-69). In
12 September 2008, Standard initiated an adversary proceeding, seeking to rescind the disability
13 income insurance policy on the basis of fraudulent misrepresentations made by debtor during
14 the application process. *See* Complaint (Bankr. W.D. Wash. Adv. No. 08-1232 at docket
15 no. 1), Appellee’s Appendix of Record (docket no. 23 at 140-44). In its Complaint, Standard
16 alleged that debtor falsely and deceptively “assured Standard that he had never applied for or
17 received any other disability insurance benefits” and “represented to Standard that he was not
18 under the care of a physician.” *Id.* at ¶¶ 6, 7, 10. Under the policy, debtor would have been
19 entitled to payments of \$3,000 per month, beginning in May 2008, until he reached the age of
20 67, sometime in the year 2039. *Id.* at ¶ 16; *see* Letter Ruling at 2; *see also* Policy Data Sheet,
21 Appellant’s Appendix (docket no. 19-2 at 25). Standard sought a declaration that the policy
22 was null and void, and asked that it be rescinded.

23 While the adversary proceeding was pending, Standard made monthly payments into
24 the bankruptcy estate’s account under a reservation of rights. James Decl. at ¶ 7 (Bankr.
25 W.D. Wash. Case No. 08-14147 at docket no. 83), Appellee’s Appendix of Record (docket
26 no. 23 at 121). As of July 8, 2009, those payments, plus interest, totaled \$52,812.17. *Id.* On

1 September 4, 2009, the Bankruptcy Court approved a settlement between Standard and the
2 Chapter 7 Trustee of debtor's bankruptcy estate (the "Trustee"), pursuant to which the
3 Trustee would retain the \$52,812.17 held in the bankruptcy estate's account, and Standard
4 would be released from all claims "related to or arising out of" the disability income
5 insurance policy. See Settlement Agreement and Release of All Claims at ¶ 3 & Order
6 Approving Compromise of Claim, attached to Notice of Appeal (Case No. C09-1422Z,
7 docket no. 1-2). The Bankruptcy Court adjudged and declared the policy to be "null, void
8 and of no force and effect, *ab initio*." Order Approving Compromise at ¶ 1. Debtor appeals
9 from this Order.

10 On the same day it approved the settlement, the Bankruptcy Court also granted partial
11 summary judgment in favor of the Trustee, thereby rejecting debtor's claim of exemption as
12 to the disability income insurance policy proceeds. See Order of Partial Summary Judgment
13 Regarding Exemptions, attached to Notice of Appeal (Case No. C09-1399Z, docket no. 1-2).
14 In her motion for partial summary judgment, the Trustee presented two alternative
15 arguments: (i) in light of debtor's failure to disclose the disability income insurance policy in
16 the schedules appended to his Voluntary Petition, and at other times during the bankruptcy
17 proceedings, debtor's claim of exemption was made in bad faith, and (ii) any exemption of
18 disability payments should be limited to the amount reasonably necessary for debtor's
19 support. See Trustee's Memorandum (Bankr. W.D. Wash. Adv. No. 08-1232 at docket
20 no. 17), Appellee's Appendix of Record (docket no. 23 at 157-63). In granting the Trustee's
21 motion, the Bankruptcy Court held that "debtor shall have no interest, control or ownership
22 rights" in the disability income insurance policy. Order of Partial Summary Judgment at
23 2:3-4. Debtor also appeals from this Order.

1 **Discussion**

2 **A. Standard of Review**

3 On appeal, the Bankruptcy Court's conclusions of law and interpretation of the
 4 Bankruptcy Code are reviewed de novo, and its factual findings are reviewed for clear error.
 5 *Greene v. Savage (In re Greene)*, 583 F.3d 614, 618 (9th Cir. 2009). This Court must accept
 6 the Bankruptcy Court's findings of fact unless, upon review, the Court is "left with the
 7 definite and firm conviction that a mistake has been committed." *Id.* In evaluating whether
 8 the Bankruptcy Court properly granted summary judgment, this Court must apply the
 9 familiar standards of Federal Rule of Civil Procedure 56(c), namely whether, viewing the
 10 evidence in the light most favorable to the non-movant, no genuine issues of material fact
 11 exist and the moving party is entitled to judgment as a matter of law. *See Suncrest*
 12 *Healthcare Ctr. LLC v. Omega Healthcare Investors, Inc. (In re RainTree Healthcare*
 13 *Corp.)*, 431 F.3d 685, 687
 14 (9th Cir. 2005). With respect to the Bankruptcy Court's approval of the compromise
 15 between Standard and the Trustee, this Court reviews only for an abuse of discretion. *Martin*
 16 *v. Kane (In re A&C Props.)*, 784 F.2d 1377, 1380 (9th Cir. 1986). Deference is owed to the
 17 Bankruptcy Court's approval of a settlement because it is "uniquely situated to consider the
 18 equities and reasonableness of a particular compromise." *United States v. Alaska Nat'l Bank*
 19 *(In re Walsh Constr., Inc.)*, 669 F.2d 1325, 1328 (9th Cir. 1982).

20 **B. Approval of Settlement**

21 Federal Rule of Bankruptcy Procedure 9019 authorizes the Bankruptcy Court, upon
 22 motion by the Trustee and after notice and a hearing, to approve a compromise or settlement.
 23 "The law favors compromise and not litigation for its own sake," and "as long as the
 24 bankruptcy court amply considered the various factors that determined the reasonableness of
 25 the compromise, the court's decision must be affirmed." *A&C Props.*, 784 F.2d at 1381.
 26 The relevant factors include: (i) the probability of success in the litigation; (ii) the

1 difficulties, if any, to be encountered in the matter of collection; (iii) the complexity of the
2 litigation, and the expense, inconvenience, and delay attending it; and (iv) the interest of the
3 creditors. Id. In appealing the Bankruptcy Court's Order Approving Compromise of Claim,
4 debtor does not allege any procedural irregularities or any failure by the Bankruptcy Court to
5 properly assess the fairness, reasonableness, and adequacy of the settlement. Indeed, the
6 Trustee's motion was noted for hearing at least thirty (30) days after filing, and it presented
7 an analysis of the relevant factors, focusing primarily on the low likelihood of success in
8 establishing that Standard was required to pay any disability benefits. See Trustee's Notice
9 and Motion for an Order Approving Compromise of Claim (Bankr. W.D. Wash. Case
10 No. 08-14147 at docket no. 82), Appellee's Appendix of Record (docket no. 23 at 103-18).

11 Instead, debtor contends that the Trustee was not authorized to settle with Standard
12 because the disability income insurance policy was not part of the bankruptcy estate. The
13 parties agree that the Trustee did not timely assume the disability income insurance policy,
14 which was an executory contract, and that the policy was therefore rejected pursuant to
15 11 U.S.C. § 365(d)(1). The parties diverge, however, on the effect of such rejection. Debtor
16 suggests that the rejection resulted in "the revesting of title back in the debtor." Opening
17 Brief at 18 (docket no. 19). Debtor's position lacks merit.

18 Rejection of an executory contract "constitutes a breach of such contract." See
19 11 U.S.C. § 365(g). It gives rise to a claim by the non-debtor party to the contract (in this
20 case, Standard), with the date of breach, for purposes of priority, being the date immediately
21 preceding the filing of the bankruptcy petition. See Med. Malpractice Ins. Ass'n v. Hirsch
22 (In re Lavigne), 114 F.3d 379, 387 (2d Cir. 1997) (citing 11 U.S.C. §§ 365(g) & 502(g)); see
23 also NLRB v. Bildisco & Bildisco, 465 U.S. 513, 530 (1984). Rejection frees the estate from
24 the obligation to perform (in this case, to pay insurance premiums), but it does not nullify,
25 invalidate, cancel, or rescind the contract, and it does not eliminate any claims or defenses
26 that the debtor had with regard to the contract. See First Ave. W. Bldg., LLC v. James (In re

1 OneCast Media, Inc.), 439 F.3d 558, 563 (9th Cir. 2006); see also In re Lavigne, 114 F.3d at
2 387.

3 Contrary to debtor's contention, rejection does not "revest" the contract in the debtor,
4 and it does not "divest" the estate of the rights that a breaching party has under the applicable
5 state law governing contracts, see OneCast, 439 F.3d at 563 (quoting In re Thompson-
6 Mendez, 321 B.R. 814, 819 (Bankr. D. Md. 2005)); rather, the rejected executory contract
7 remains property of the estate,¹ but it is unenforceable against the estate. Alert Holdings, Inc.
8 v. Interstate Protective Servs., Inc. (In re Alert Holdings, Inc.), 148 B.R. 194, 203 (Bankr.
9 S.D.N.Y. 1992); see In re Thompson-Mendez, 321 B.R. at 820 ("an executory contract or
10 unexpired lease that is rejected under 11 U.S.C. § 365(d)(1) is breached, but is not
11 abandoned" and "the debtor's interest in the [contract or] lease remains property of the
12 estate"); see also In re Henderson, 245 B.R. 449, 453-54 (Bankr. S.D.N.Y. 2000) (absent
13 direct or formal abandonment of a residential lease, the lease remains property of the estate
14 even though it was rejected by the trustee).

15
16 ¹ Debtor cites Cheadle v. Appleatchee Riders Ass'n (In re Lovitt), 757 F.2d 1035 (9th Cir. 1985), for the
17 proposition that an executory contract does not become part of the bankruptcy estate until it is assumed by
18 the Trustee. See id. at 1041. Lovitt, however, involved the former Bankruptcy Act of 1898, rather than the
19 current Bankruptcy Code. See id. at 1040 & n.3. Under the previous Act, a trustee was vested with title to
20 property of the estate; under the present Code, the same is not true. See Alert Holdings, 148 B.R. at 203
21 (citing § 70(a) of the Bankruptcy Act & § 541 of the Bankruptcy Code). Moreover, Lovitt is inconsistent
22 with Ninth Circuit authority concerning the automatic stay provisions of the now applicable Code. See
23 Minoco Group of Cos., Ltd. v. First State Underwriters Agency (In re Minoco Group of Cos., Ltd.), 799 F.2d
24 517 (9th Cir. 1986). The filing of a bankruptcy petition operates to stay "any act to obtain possession of
25 property of the estate or of property from the estate or to exercise control over property of the estate." 11
26 U.S.C. § 362(a)(3). In Minoco, the Ninth Circuit held that liability insurance policies constituted property of
the bankruptcy estate as to which the automatic stay barred cancellation by the insurer absent relief from the
stay granted pursuant to § 362(d). 799 F.2d at 518-20. Because a Chapter 7 trustee has 60 days to decide
whether to accept or reject executory contracts, 11 U.S.C. § 365(d)(1), the conclusion follows that, for the
automatic stay provisions of the Code to have meaning with respect to such matters, the executory contracts
must be "property of the estate" before the trustee elects to accept or reject them. Finally, both Lovitt and
Otto Preminger Films, Ltd. v. Qintex Entm't, Inc. (In re Qintex Entm't, Inc.), 950 F.2d 1492 (9th Cir. 1991),
which relies on Lovitt, are distinguishable because they involved attempted sales by the respective trustees of
the unassumed contracts to bona fide purchasers. In those cases, because the trustees did not assume the
contracts, the trustees lacked authority to sell or transfer them. In contrast, in this case, the Trustee did not
sell or assign the rejected contract to another entity; rather, the Trustee negotiated a settlement with the other
party to the contract, which asserted it had no obligation to perform under the contract.

1 Although the adversary proceeding initiated by Standard did not seek to enforce the
2 contract or to obtain the insurance premiums due under the contract, but rather to avoid or
3 rescind the contract, the fact remains that the contract, *i.e.*, the disability income insurance
4 policy, was an asset of the estate as to which the Trustee was a properly named party. Thus,
5 the Trustee had authority to negotiate a settlement and to seek approval of the compromise
6 by the Bankruptcy Court. *See* Fed. R. Bankr. P. 9019(a). To be clear, the \$52,812.17 at
7 issue constitute proceeds of settlement, and not payments made under the rejected disability
8 income insurance policy, and the funds are appropriately treated as part of the bankruptcy
9 estate. The Trustee's decision to accept the amount in question in lieu of further litigation
10 was reasonable in light of Standard's likelihood of establishing that debtor made material
11 misrepresentations on his application and that, as a result, no disability benefits were owed to
12 debtor. Thus, the Bankruptcy Court's Order Approving Compromise of Claim was a proper
13 exercise of discretion, and it is hereby AFFIRMED.

14 **C. Disallowance of Exemption**

15 The Bankruptcy Code lists exemptions that a debtor may claim in a bankruptcy
16 proceeding. *See* 11 U.S.C. §§ 522(b)&(d). If allowed, an exemption operates to remove the
17 exempt item from the "property of the estate." 11 U.S.C. § 522(b)(1). Individual states may
18 "opt out" of the exemptions in § 522, but Washington has not taken such step. *See*
19 RCW 6.15.010; RCW 48.18.400. Thus, in this case, the Bankruptcy Code governs what
20 exemptions are allowed. *See* 11 U.S.C. § 522(b)(2); *see also In re Yau*, 115 B.R. 245, 248
21 (Bankr. C.D. Cal. 1990).

22 Debtor asserts that the disability income insurance policy at issue falls within the
23 exemption outlined in § 522(d)(10)(C), which permits an exemption for the "right to receive
24 . . . a disability, illness, or unemployment benefit." The Trustee contends that, if an
25 exemption is available, the applicable provision is § 522(d)(10)(E), which describes the
26 "right to receive . . . a payment under a stock bonus, pension, profitsharing, annuity, or

1 similar plan or contract on account of . . . disability, . . . to the extent reasonably necessary
2 for the support of the debtor.” 11 U.S.C. § 522(d)(10)(E) (emphasis added). For support, the
3 Trustee cites *In re Wegrzyn*, 291 B.R. 2 (Bankr. D. Mass. 2003), which stands for the
4 proposition that § 522(d)(10)(C) relates to government benefits, while § 522(d)(10)(E)
5 governs privately funded or long-term disability benefits. The Bankruptcy Court, however,
6 did not reach this issue, and whether any exemption would be limited in the manner set forth
7 in § 522(d)(10)(E) is not before the Court on appeal.

8 The only topic for the Court’s review is whether the Bankruptcy Court properly
9 granted summary judgment in favor of the Trustee on the ground that debtor acted in bad
10 faith and was therefore precluded from claiming an exemption as to the disability income
11 insurance policy. Approximately six months before the Bankruptcy Court ruled on the
12 Trustee’s summary judgment motion, it conducted a trial in a different, but related adversary
13 proceeding brought by the United States Trustee (the “UST”), seeking to deny discharge due
14 to concealment of assets and false oaths. The Bankruptcy Court found that debtor
15 intentionally concealed the disability income insurance policy at issue with the intent to
16 hinder, delay, or defraud his creditors and that he knowingly and fraudulently made false
17 oaths in failing to disclose the policy. *See* Letter Ruling at 6-7, Appellee’s Appendix of
18 Record (docket no. 23 at 173-74). As a result, the Bankruptcy Court denied discharge
19 pursuant to 11 U.S.C. §§ 727(a)(2)(B) & 727(a)(4)(A). *Id.* The Bankruptcy Court’s decision
20 has since been affirmed by the Bankruptcy Appellate Panel of the Ninth Circuit (“BAP”).
21 *See* Statement of Decision in Related Proceedings (docket no. 27).

22 Debtor presents to this Court many of the explanations for failing to timely disclose
23 the disability income insurance policy that the Bankruptcy Court rejected during the course
24 of the adversary proceeding initiated by the UST. Debtor separately challenged the
25 Bankruptcy Court’s factual findings concerning the concealment of assets and rendering of
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1 false oaths, and those findings have already been affirmed by the BAP. Thus, whether those
2 findings are supported by the evidence presented at trial is not before this Court.

3 The Court, however, must address debtor's contention that those findings were not
4 res judicata in connection with the Trustee's motion to disallow an exemption under
5 § 522(d)(10). Debtor makes two arguments: (i) he contends that the standard of proof for
6 bad faith is higher (*i.e.*, clear and convincing evidence) than the standard of proof applied in
7 the adversary proceeding brought by the UST (*i.e.*, preponderance of the evidence); and
8 (ii) he asserts that, because the parties in the respective adversary proceedings were different,
9 a trial should also have been conducted concerning the Trustee's objection to his claim of
10 exemption.

11 Debtor is incorrect about the standard of proof for bad faith. The cases he cites
12 concern the standards (i) for sanctioning an attorney, Kismet Acquisition, LLC v. Icenhower
13 (In re Icenhower), 406 B.R. 42 (Bankr. S.D. Cal. 2009); (ii) for holding a patent invalid
14 based on fraud, Carpet Seaming Tape Licensing Corp. v. Best Seam Inc., 694 F.2d 570 (9th
15 Cir. 1982); (iii) for dismissing an involuntary petition on the basis of the filing creditors' bad
16 faith, as to which the debtor bears the burden of proof, In re Molen Drilling Co., 68 B.R. 840
17 (Bankr. D. Mont. 1987); (iv) for a debtor to rebut the presumption of bad faith filing arising
18 under 11 U.S.C. § 362(c)(3)(C), In re Montoya, 342 B.R. 312 (Bankr. S.D. Cal. 2006);
19 In re Castaneda, 342 B.R. 90 (Bankr. S.D. Cal. 2006); and (v) for precluding a debtor from
20 amending lists or schedules, Magallanes v. Williams (In re Magallanes), 96 B.R. 253 (B.A.P.
21 9th Cir. 1988); In re Myatt, 101 B.R. 197 (Bankr. E.D. Cal. 1989). None of these cases
22 address the burden of proving bad faith in exemption proceedings. In contrast, the relevant
23 authorities indicate that the applicable standard of proof is preponderance of the evidence,
24 which provides "a roughly equal allocation of the risk of error between litigants." Bauer v.
25 Iannacone (In re Bauer), 298 B.R. 353, 356 (B.A.P. 8th Cir. 2003) (quoting Grogan v.
26 Garner, 498 U.S. 279, 286 (1991)); *see also* In re Ford, 492 F.3d 1148, 1155 (10th Cir.

1 2007) (“For the same reasons set forth by the Supreme Court in Grogan, we conclude a
2 preponderance of the evidence standard governs the evaluation of bad faith in the context of
3 a debtor seeking an exemption. The preponderance of evidence standard strikes a fair
4 balance between the goal of encouraging disclosure and protecting creditors.”).

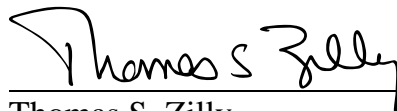
5 Debtor is also incorrect about the need for identical parties. Res judicata generally
6 refers to the preclusive effect of former litigation. Paine v. Griffin (In re Paine), 283 B.R.
7 33, 38 (B.A.P. 9th Cir. 2002). Res judicata has two conceptual categories: (i) claim
8 preclusion; and (ii) issue preclusion, often called “collateral estoppel.” Id.; see also Alary
9 Corp. v. Sims (In re Associated Vintage Group, Inc.), 283 B.R. 549, 555 (B.A.P. 9th Cir.
10 2002). Both claim and issue preclusion apply in bankruptcy. Paine, 283 B.R. at 39. The
11 key distinction between the two types of preclusion is that matters never litigated may be
12 barred by claim preclusion, while only matters actually litigated may be barred by issue
13 preclusion. Associated Vintage, 283 B.R. at 555. Although claim preclusion requires that
14 the parties be identical or in privity, issue preclusion does not demand a similar showing.
15 This case involves issue preclusion. Issue preclusion is appropriate when (i) the previous and
16 current proceedings involve the same issue; (ii) the issue was actually litigated and
17 determined;
18 (iii) the prior decision is valid and final; and (iv) the determination of the issue was essential
19 to the prior decision. Paine, 283 B.R. at 39. These elements were met in this instance, and
20 the Bankruptcy Court’s findings in the UST’s adversary proceeding precluded debtor from
21 relitigating the underlying basis for the Trustee’s bad faith objection to debtor’s claim of
22 exemption as to the disability income insurance policy, i.e., failure to timely disclose the
23 asset. The Bankruptcy Court’s Order of Partial Summary Judgment Regarding Exemptions
24 is therefore AFFIRMED.

1 **Conclusion**

2 For the foregoing reasons, Bankruptcy Judge Karen A. Overstreet's Order Approving
3 Compromise of Claim, entered as docket no. 108 in Case No. 08-14147-KAO (Bankr. W.D.
4 Wash. Sep. 4, 2009), and Order of Partial Summary Judgment Regarding Exemptions,
5 entered as docket no. 45 in Adversary Proceeding No. 08-1232-KAO (Bankr. W.D. Wash.
6 Sep. 4, 2009), are both AFFIRMED. Debtor's Emergency Motion for Stay Pending Appeal,
7 docket no. 5, and debtor's Motion for Leave to Appeal Denial of Summary Judgment, docket
8 no. 20, are STRICKEN as moot. The stay of disbursement of the approximately \$52,000
9 held in the bankruptcy estate as a result of the settlement between the Trustee and Standard,
10 imposed by Minute Order dated December 10, 2009, docket no. 13, is hereby LIFTED, and
11 such funds may be disbursed as the Bankruptcy Court directs. The Clerk is directed to enter
12 judgment consistent with this Order, to CLOSE this case, and to send a copy of this Order to
13 all counsel of record, to debtor pro se, and to Bankruptcy Judge Karen A. Overstreet.

14 IT IS SO ORDERED.

15 DATED this 30th day of July, 2010.

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18 Thomas S. Zilly
19 United States District Judge
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